COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

REAUTHORIZATION OF THE COMMODITY FUTURES TRADING COMMISSION

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FUTURES INDUSTRY ASSOCIATION

MARCH 9, 2005

Chairman Moran, Ranking Member Etheridge, members of the Subcommittee, I am John Damgard, president of the Futures Industry Association (FIA). On behalf of FIA, I want to thank you for the opportunity to appear before you today. FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants (FCMs) in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members serve as brokers for more than ninety percent of all customer transactions executed on United States contract markets.

Little more than four years ago, Congress passed and President Clinton signed into law the Commodity Futures Modernization Act (CFMA). With the goal of promoting "responsible innovation and fair competition among boards of trade, other markets and market participants," the CFMA amended the Commodity Exchange Act to:

- Authorize the Commission to develop a regulatory program for markets that would be "tailored to match the degree and manner of regulation to the varying nature of the products traded thereon, and to the sophistication of the customer;"

- Remove the 20-year prohibition on futures on individual securities and narrow-based securities index contracts and, in another radical departure, provided for the joint regulation of these products by the Commission and the Securities and Exchange Commission; and

- Assure legal certainty for over-the-counter derivatives.

The CFMA signaled a dramatic, new approach to the regulation of the derivatives markets and, as such, placed enormous demands on the Commission and its staff as they developed the regulations necessary to implement its myriad provisions. They have met the challenge, and we appreciate their efforts. While FIA and the CFTC do not see eye to eye on every issue, we believe the CFTC is an excellent federal agency that discharges its

statutory obligations in an efficient and effective manner. The CFTC's past and present leadership is to be commended for this record. The CFTC deserves to be reauthorized.

This morning, I want to discuss four issues that FIA believes should be addressed in order to fulfill the promise of the CFMA: promoting fair competition, SRO governance; security futures; and over the counter retail foreign currency (FX) transactions. In each of these areas with one exception (retail FX fraud), it may be possible to address our concerns without specific legislation. At this time, therefore, we are not proposing language to amend the statute. We will continue to work with the Commission and other entities in the futures industry to find both non-legislative and legislative solutions. Nonetheless, at this stage of the process, we want to let you know what issues are of most importance to our members.

Fair Competition. Promoting fair competition should be the goal of any sound regulatory program. Our strong support for the CFMA was based in substantial part on our belief that competition, rather than a prescriptive regulatory structure that established excessively high barriers to entry, would be the best regulator. We fully anticipated that the CFMA's regulatory reforms would encourage new entrants to apply for designation with the Commission as contract markets or clearing organizations. These new self-regulatory organizations would compete among themselves and with the existing exchanges for customer business based on products, quality of execution and cost.

Robust competition facilitates the ability of U.S. futures markets to serve the public interest. Competition leads to reduced costs, higher volumes, narrower spreads and greater innovation. It is true that the efforts of the challenger markets to date have not been successful in doing more than chipping away at the entrenched markets' dominance. Nonetheless, we have seen that some benefits of competition may be achieved, at least in part and for some period of time, even when direct meaningful competition is only threatened, but not realized.

The Chicago Board of Trade's U.S. Treasury security complex is a good example. Spurred by a string of exchanges attempting to offer direct competition in recent years, including the largest derivatives exchange in the world (EUREX), the CBOT has embraced electronic trading and lowered trading costs. The result? Record CBOT trading volumes, greater liquidity, narrower bid-ask spreads and ultimately lower taxpayer costs for funding U.S. government debt. This competitive threat also accelerated first the acceptance and then the recent expansion of electronic trading at the CBOT.

This is just one example. In addition, Euronext Liffe now attempts to compete with the Chicago Mercantile Exchange for Eurodollar futures trading. The CBOT is challenging the COMEX, a division of the New York Mercantile Exchange, for gold and silver futures trading. The IntercontinentalExchange, even without offering futures contracts, competes with the New York Mercantile Exchange for clearing of off-exchange products and trading in energy derivatives.

This incipient competition has even sparked movement in overseas markets. The CBOT is attempting to compete with Eurex for futures trading volume in the German government-issued debt securities the Bund, Bobl and Schatz. And NYMEX has announced plans to face off in London with the International Petroleum Exchange for trading in Brent Oil futures. In sum, at no time in the futures industry's history have we seen as much head to head, direct product competition among markets.

While competition has a very positive influence on markets, it presents certain regulatory challenges. These are most pronounced under the Commodity Exchange Act, which was not designed with these forms of direct competition in mind. Traditionally, once a market achieved liquidity and dominance in a particular product, no challenger emerged. Traditionally, trading and clearing were inextricably linked, one function supported the other and shut out potential competitors that might want to offer similar services. In fact, traditionally, few markets even attempted to challenge dominant markets by offering a new contract design, method of trading or clearing efficiency.

But now that is slowly beginning to change, as the market experience over the past four years shows. More and more, the CFTC's role is evolving to become a referee of competitive disputes between two or more direct competitors for the same product or related clearing services. In each of these struggles—Eurex v. CBOT, Euronext v. CME, ICE v. NYMEX—the CFTC has been called upon to resolve or consider claims of unfair competition. In the ICE v. NYMEX case, even the courts are looking to the CFTC to play a special role in resolving competitive disputes.

This phenomenon raises the question whether the CFTC has the statutory tools to ensure that it can deliver what all referees seek: fair competition under rules of the game that are transparent to all participants. FIA urges this Subcommittee to consider carefully whether reforms are needed in the Act to give the CFTC adequate authority and to give market participants adequate confidence that the CFTC is making sure that no exchange is gaming the system to achieve an unfair competitive advantage.

One area that illustrates some of these issues is self-certification of exchange rule changes. Under current law, an exchange or a derivatives clearing organization has a choice: it may submit a rule for CFTC approval or it may put into effect immediately virtually any rule—no matter its real competitive impact—by self-certifying that the rule complies with the CEA and the relevant core principles. This change in the law was enacted in 2000 to give exchanges the flexibility to respond quickly to market developments without having to obtain CFTC prior approval of rule changes. Usually those rules, especially when adopted in a competitively sensitive area, are not released publicly before the self-certified rule is submitted to the CFTC.

At that point, the CFTC has the authority to take the serious step of rescinding the exchange's self-certified rule change and insisting that the rule be resubmitted for pre-approval. The CFTC, naturally and practically, is reluctant to interfere with the judgment

of an exchange or designated clearing organization. But the CFTC has no process in place to solicit public input on self-certified rules and, therefore, has no way to assess formally the potential competitive impact of an exchange's rule change.[1]

And what if the CFTC takes no action, but a competitor exchange or market participant can make a legitimate claim that the rule change actually constitutes an unreasonable restraint of trade or would otherwise result in unfair competition? The CEA is unclear on what remedies are available to the aggrieved party. No process exists to petition the CFTC or for automatically delaying the effectiveness of an exchange rule that could give the self-certifying market an unfair competitive advantage. As a result, the aggrieved party's only remedies may be litigation under the antitrust laws and the Administrative Procedure Act. That is not the best way to resolve those kinds of disputes. We would like to work with the Subcommittee, the Commission, the exchanges and other relevant parties to try to build a better process for making sure the self-certification authority does not become a haven for unfair competitive tactics.

Finally, some believe that unless or until Congress or the CFTC mandates contract fungibility among exchanges the potential benefits of meaningful direct competition will never be realized. (Fungibility means, for example, that a "long" contract entered into on Exchange #1 could be offset by a mirror-image "short" contract on Exchange #2 through cooperative or common clearing, and vice versa.) Fungibility gives customers the ability to choose their market and obtain the best price available for an offsetting trade, even if the market with the best price is not the market where the original position was established.[2] These are salutary goals we believe everyone should support in the interest of serving the customer and enhancing competition. Yet, established exchanges are reluctant to surrender their market advantages and would surely oppose efforts by the CFTC to impose fungibility by rule.

As noted above, the efforts of the challenger markets to date have done little more than chip away at the entrenched markets' dominance. At this time, however, FIA is not asking this Subcommittee to consider amendments to mandate fungibility. We believe that further study of the current regime of direct competition without fungibility under the CEA is needed before Congress considers such a major reform.

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[1] FIA's concerns about the internal exchange rule approval process and the Commission's lack of procedures for soliciting comment on exchange rules that have been submitted for approval are set forth in a later section of this testimony. (Infra at p. 5.) We have focused on the self-certification of rules in this section in order to illustrate the implications that new authority may have where dueling exchanges could be submitting conflicting or confusing self-certifications of rules as a means for responding to their direct competitors.

[2] Fungibility also would encourage customers to enter into original positions on a challenger exchange when that exchange offers the customer the better price. The customer then could offset that same position on the dominant exchange.

SRO Governance. FIA supports the important role that the exchanges, clearing organizations and the National Futures Association (NFA) perform as self-regulatory organizations (SROs) and designated self-regulatory organizations (DSROs). Given their strong market knowledge and close proximity to the trading markets, they provide the best vantage point for addressing many of the futures markets' oversight functions. However, to be fully effective, there must be an increased degree of public confidence in the integrity and objectivity of SROs.

The Commission, the several self-regulatory organizations and the derivatives industry generally must act to remove the real and perceived conflicts of interest and potential for anti-competitive conduct that are inherent in any self-regulatory structure. We believe that specific modifications to the SRO structure can increase its overall efficiency and effectiveness. In addition, a clear delineation of the role and responsibility of the Commission in proactively overseeing these SRO functions will enhance SRO performance and public confidence in the SRO structure. We presented our recommendations in this area to the Commission in a position paper and subsequent comment letter on governance of self-regulatory organizations in June 2004. We have attached these documents for the Subcommittee's consideration. In the event the Commission concludes it needs additional statutory authority to implement these recommendations, we summarize two of our recommendations for your consideration.

Certain of the core principles enacted in the CFMA form the foundation of our recommendations. Specifically:

- Core principle 15 requires exchanges to "establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest;" and

- Core principle 18 requires exchanges "to avoid (1) adopting any rule or taking any action that results in any unreasonable restraint of trade, or (2) imposing any material anticompetitive burden on trading," "unless appropriate to achieve the purposes of the Act".[3]

Participation in Rulemaking. The rules that an SRO adopts and the manner in which it enforces them are critical to complying with these core principles and, as important, to properly meeting its responsibilities as an SRO.

Among other requirements, section 5(b) of the Act, which sets out the criteria for designation as a contract market, imposes on exchanges the obligation to adopt and enforce rules (1) to ensure fair and equitable trading, (2) to ensure the financial integrity

[3] In a statutory anomaly, the core principle for contract markets and anticompetitive conduct appear to be more lenient that the core principle for derivatives clearing organizations and anticompetitive conduct. The Subcommittee may want to revisit these principles and harmonize them. FIA sees no reason for different statutory formulations of an SRO's duty to avoid anticompetitive outcomes from its actions.

of transactions entered into by or through the facilities of the exchange, (3) to prevent market manipulation, and (4) to discipline members or market participants that violate such rules.

To both enhance the quality of SRO rulemaking and engender confidence in the SRO rulemaking process generally, the procedures by which an SRO adopts and enforces these rules should be transparent and should assure that members and other market participants, not just one constituency, have an opportunity to express their views and otherwise participate in the process. The ability of market participants to have a role in developing the four categories of rules referenced above is particularly important, since they are most directly affected by such rules. In this regard, it generally would not be acceptable if such rules were developed solely by SRO staff and approved by the independent directors of the exchange or independent members of a committee.

Neither the Act nor the Commission's rules prescribe the procedures that an SRO should follow in adopting rules. Nonetheless, we believe the essential elements of these procedures are implied in Part 40 of the Commission's rules. These rules require an exchange to describe any substantive opposing views expressed with respect to the proposed rule that were not incorporated into the proposed rule. Further, an SRO, in submitting a rule for approval, must include in its submission an explanation of the operation, purpose and effect of the rule, including, as applicable, a description of the anticipated benefits, any potential anticompetitive effects, and how the rule fits into the framework of self-regulation.

Part 40 contemplates an open, fully informed internal process before an SRO adopts a rule. We do not understand how the Commission could properly determine whether the SRO's rules violate applicable core principles—including the requirement that the SRO endeavor to avoid adopting any rule that results in an unreasonable restraint of trade or imposes any material anticompetitive burden on trading—unless the SRO's rulemaking procedures are designed to solicit input from members and affected market participants on significant rule proposals.

To the extent that affected market participants are not afforded an opportunity to have their views taken into account when an SRO adopts rules, they must have the opportunity to seek redress with the Commission. Transparency in the Commission's consideration of SRO rules and the opportunity for public participation in this process is no less important than in an SRO's adoption of such rules. In appropriate circumstances, a request for comment should be published in the *Federal Register* as well as on the Commission's website, and the public should be afforded a reasonable amount of time to analyze the rules and prepare comments. The Commission's decision with respect to such rule, including its analysis of the comments received, should also be made available to the public.

We want to be clear that FIA is not seeking a return to the rule review procedures that were in place prior to the enactment of the CFMA. Nonetheless, it may be

appropriate to identify a select category of rules, primarily those relating to clearing and certain trading rules, on which market participants should be afforded the right to comment, either at the exchange level or at the CFTC.

Director Independence. To minimize the risk that an SRO could use its regulatory authority for inappropriate purposes, or fail to use it in necessary circumstances, SRO boards and committees should include more independent members. In particular, a committee of the exchange/clearing house board of directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities.

The independent board committee should have direct and unfettered access to information to ensure that it is making fully informed decisions. Further, it should have the ability to retain independent outside counsel in appropriate circumstances. Finally, FIA believes that the nomination process for independent directors of SROs should be free of management or member influence. Accordingly the nominating committee for the independent SRO board supervisory committee should be comprised only of independent individuals who meet the requisite independence test for directors.

FIA continues to have concerns about some definitions of "independent director." We are not convinced that current exchange and others' definitions of "independent" are adequate to achieve true independence. Some current standards define "independence" merely as not having a relationship with the SRO as an entity. Consequently, exchange members are considered independent, a result with which we respectfully disagree. At a minimum, FIA believes that true independent directors should not be currently active in the industry or too recently associated with an SRO member.

The Commission should use its authority under the Act to require SROs to implement the reforms outlined above and to ensure continued compliance. These changes would ensure greater independence of the board generally and the key committee described above to screen out inappropriate appearances of bias or conflicts. As a consequence, the changes would help SROs achieve the goal of greater independence of the regulatory function.[4]

Security Futures Products. FIA has devoted significant time and resources since the enactment of the CFMA, in working with the CFTC, the SEC and the exchange community to implement both the spirit and the letter of the provisions authorizing trading in security futures products. Although volume on these markets has not been as robust as we would like, we continue to believe that this is an important product that will grow over time.

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[4] In a letter to the Commission commenting on proposed revisions to the Joint Audit Agreement to be entered into among the several self-regulatory organizations, FIA made certain recommendations concerning the allocation of SRO responsibilities. This letter is attached to this testimony for the Subcommittee's information.

U.S. futures exchange representatives have made suggestions for changing the law to expand and enhance the trading of security futures products on U.S. markets. We fully support the U.S. exchanges in this effort. FIA wants to be certain that its members and their customers are able to trade as many diverse and innovative contracts on exchanges as possible in order to enjoy the many benefits exchange trading affords. In this regard, FIA would support a careful examination of the regulatory structure governing security futures products to determine whether that structure is unnecessarily inhibiting the growth of these products in the U.S.

However, U.S. institutional investors are also being thwarted in their desire to trade futures on individual securities and narrow-based security index futures contracts traded on a non-U.S. exchange. These instruments could be of significant value to customers for various purposes, including risk management and asset allocation. Although volume in security futures products has grown slowly on OneChicago, the only U.S. exchange listing security futures products, growth on non-U.S. exchanges has exploded. From 2003 to 2004, for example, volume in futures on individual securities grew 58 percent, from approximately 54.3 million contracts to approximately 85.7 million contracts. On Euronext Liffe in London, volume in futures on individual securities doubled and surpassed the volume in options on individual equities.

In enacting the provisions authorizing security futures products, Congress instructed the SEC and the CFTC **"**to the extent necessary and appropriate in the public interest, to promote fair competition, and consistent with promotion of market efficiency, innovation and expansion of investment opportunities**"** to **"**issue such rules regulations or orders as may be appropriate to permit the offer and sale of a security futures product traded on or subject to the rules of a foreign board of trade to United States persons.**"** Consistent with this explicit congressional direction, FIA had been assured that necessary rules or orders permitting the offer and sale of foreign security futures products to U.S. persons would be adopted contemporaneously with the rules authorizing security futures products on U.S. exchanges. However, the CFTC and SEC have failed to take any action to permit U.S. customers to trade futures on individual securities or on narrow-based indices listed for trading on non-U.S. exchanges.

The only action the CFTC and SEC have taken with respect to non-U.S. security futures products is to issue an order to confirm that U.S. customers could continue to trade those broad-based foreign index contracts that had been approved for trading prior to the enactment of the CFMA. This order was necessary because the agencies have not adopted a rule to define a narrow-based index in the context of a non-U.S. index.

The investment objectives of pension plans, investment companies, endowments, hedge funds and other large money managers that FIA members serve have been restricted by the agencies' failure to act. Those institutional customers are free to engage in transactions in the international securities markets with few regulatory limitations. Moreover, these institutions are authorized to enter into principal-to-principal derivatives transactions that replicate foreign security index contracts, but may be more difficult, and

substantially more expensive, to effect than exchange-traded instruments. In these circumstances, no U.S. regulatory purpose is served by preventing U.S. institutional customers, in particular, from using foreign futures on narrow-based index or single securities, provided that a U.S. stock exchange is not the primary market for the securities underlying such security futures products.

We urge the Subcommittee to direct the CFTC and the SEC to adopt the rules that were contemplated under the CFMA. If the agencies believe that they need additional statutory authority, they should so advise the Subcommittee so that appropriate amendments can be added to the CFTC's reauthorization legislation.

Over the Counter Foreign Currency Transactions. The last topic that I want to discuss with you concerns over the counter foreign currency transactions. As the Subcommittee will recall, the CFMA amended the Act to remove the legal uncertainty arising from the so-called Treasury Amendment to the Act that was first adopted in 1974. The amendments, which implemented the recommendations of the President's Working Group on Financial Markets, had two essential elements.

First, the Commission would have no jurisdiction over OTC foreign currency futures and options transactions effected between eligible contract participants, as defined in the Act. Second, retail customers could effect OTC foreign currency futures and options transactions only if the customer's counterparty for that transaction was among a group of otherwise regulated entities, including banks, broker-dealers and futures commission merchants. Although not expressly stated in the amendments, OTC futures and options transactions effected between retail customers and counterparties that were not among the group of otherwise regulated entities would be subject to the exchange-traded requirements of section 4(a) of the Act and, therefore, illegal. In order to enforce that ban, the CFTC would have to prove in court that the offending transactions were futures or options.

It is important to stop here to emphasize that the CFMA provided the CFTC with these special enforcement powers solely with respect to transactions that are futures or options on foreign currency. The amendments did not purport to grant the Commission jurisdiction over cash and forward contracts. Under the CFMA, the active cash and forward markets in foreign currency would continue to fall outside of the Commission's jurisdiction. (Historically, of course, cash and forward transactions on all commodities have been excluded from the Commission's jurisdiction.) Second, the amendments did not grant the Commission exclusive jurisdiction with respect to such transactions or pre-empt the application of other applicable federal and state laws, both criminal and civil.

The past four years have seen a steady stream of unregistered and unregulated entities engaging in widespread sales practice and financial fraud in connection with off-exchange foreign currency transactions with retail customers. Significantly, these entities have attempted to avoid CFTC prosecution by claiming not to be offering futures on foreign currency. To the contrary, the agreements between these entities and their

customers stated that these transactions would be conducted on the spot market. Nonetheless, applying a multi-factor approach first blessed by the 9th Circuit in *CFTC v. Co-Petro Marketing Group, Inc.*, the Commission has taken the position that these transactions are futures transactions and, therefore, illegal.

The Commission has carried the fight against foreign currency fraud virtually alone, with some help from the Department of Justice. (NFA, of course, has authority to investigate or bring actions against only those entities that are registered and are members of NFA.) With the decision of the 7th Circuit in *CFTC v. Zelener* concerning the legal tests for proving that a transaction is a futures contract, however, the Commission's jurisdiction in this entire area has been called into question. In that case, the court rejected the multi-factor approach and, focusing solely on the terms of the customer agreement, held that the so-called "rolling spot" contracts offered by the defendants were, in fact, spot contracts and not futures contracts.

FIA agrees that the CFMA's approach to granting the Commission enforcement jurisdiction over retail fraud in foreign currency (FX) transactions was imperfect. If Congress determines that the CFTC should use its resources to prosecute retail FX fraud without regard to the nature of the transactions—that is, the CFTC should exercise its antifraud authority over spot and forward transactions as well as futures and options—FIA is committed to working with the Commission, NFA and others in the industry to develop appropriate legislation.

However, any such legislation must be carefully tailored to address this specific problem. We are concerned that the temptation would be to draft legislation that is broad in scope in order to address all OTC transactions in all commodities where a retail participant is a counterparty could inadvertently interfere with legitimate risk management transactions entered into by commercial parties, including, for example, hedge-to-arrive contracts used by many in the agricultural community.

In closing, I would like to remind the Subcommittee that the challenge of combating off-exchange fraud is not new in the CFTC's history. The "open season" provisions in section 12(e) of the Act were adopted in 1982 at the request of the Commission, led by Chairman Philip McBride Johnson, the first chairman appointed by President Reagan. As Chairman Johnson noted, the Commission, given its small size, "simply cannot act as a national fraud strike force." In testimony before the Subcommittee on Conservation, Credit and Rural Development, Chairman Johnson added:

> In recent years, we have witnessed a trend to fraudulent operations with a "commodity" theme. It is increasingly apparent that the Commission, with its limited budget and resources cannot possibly put a stop to these frauds if it is the only cop on the beat.[5]

[5] Further clarifying the limited scope of the Commission's jurisdiction, Congress also amended the definition of a commodity trading advisor. Prior to the 1982 Act, a commodity trading advisor was broadly

In developing legislation to grant the Commission special antifraud authority over OTC foreign currency transactions, therefore, we must be careful not to do anything that would inadvertently discourage state authorities and other federal agencies, such as the Federal Trade Commission, from devoting resources to fighting what is nothing more than a form of consumer fraud. The Commission's primary focus should remain the regulation and oversight of the exchange markets and its participants.

Thank you again for the opportunity to appear with before you today. I would be happy to answer any questions you may have.

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defined to include any person who was engaged in the business of providing advice "as to the value of commodities," including cash and forward market transactions. As amended in the 1982 Act, a commodity trading advisor is defined as any person providing advice "as to the value of or advisability of trading in any contract for futures delivery made on or subject to the rules of any contract market, any commodity option authorized under section 4c, or any leverage contract authorized under section 19 of this Act." That is, a person is required to be registered as a commodity trading advisor only if that person is providing advice with respect to transactions that fall within the Commission's exclusive jurisdiction.